

IN THE UNITED STATES DISTRICT COURT FOR THE
WESTERN DISTRICT OF WASHINGTON

UNITED STATES OF AMERICA,)	
)	Case No.
Petitioner,)	
)	PETITION TO ENFORCE
v.)	INTERNAL REVENUE SERVICE
)	SUMMONS
MICROSOFT CORPORATION,)	
)	
Respondent.)	
_____)	

The United States of America, through undersigned counsel, hereby petitions this Court for an order enforcing an Internal Revenue Service (“IRS”) designated summons served on respondent Microsoft Corporation and includible subsidiaries (“Microsoft”), pursuant to 26 U.S.C. § 7602. In support of this petition, the United States alleges as follows:

1. This is a proceeding brought pursuant to Sections 7402(b) and 7604(a) of the Internal Revenue Code (Title 26, United States Code) for judicial enforcement of the Internal Revenue Service summons described below.

2. Microsoft’s principal place of business is in Redmond, Washington.

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1 3. The Court has jurisdiction over this proceeding pursuant to Sections 7402(b) and
2 7604(a) of the Internal Revenue Code and 28 U.S.C. §§ 1340 and 1345. Venue properly lies
3 within this district.

4 4. The IRS is conducting an examination of the federal income tax liabilities of
5 Microsoft for the taxable periods ending June 30, 2004, June 30, 2005, and June 30, 2006 (the
6 “2004-2006 Examination”). (Declaration of Senior International Advisor Eli Hoory (“Hoory
7 Decl.”), at ¶ 2).

8 5. Eli Hoory is a Senior International Advisor assigned to advise the 2004-2006
9 Examination on transfer pricing issues under 26 U.S.C § 482. (Hoory Decl., ¶¶ 1, 4).

10 6. Douglas M. Odell is a Revenue Agent employed in the Large Business and
11 International Division of the IRS and is authorized to issue administrative summonses pursuant
12 to 26 U.S.C. § 7602, 26 C.F.R. § 301.7602-1, and IRS Delegation Order No. 25-1. Revenue
13 Agent Odell is an International Examiner assigned to the 2004-2006 Examination. (Hoory Decl.,
14 ¶¶ 5-7).

15 7. In furtherance of the 2004-2006 Examination and in accordance with 26 U.S.C.
16 §§ 7602 and 6503(j), on October 30, 2014, Revenue Agent Odell issued an IRS designated
17 summons to Microsoft. The summons directed Microsoft to appear on November 20, 2014, and
18 to produce for examination books, records, papers, and other data as described in the summons.
19 (Hoory Decl., ¶ 8), Exhibit A.

20 8. On October 30, 2014, in accordance with 26 U.S.C. § 7603, Revenue Agent Odell
21 served an attested copy of the summons on Microsoft by personally delivering it to corporate
22 officer Brad Smith, Executive Vice President and General Counsel for Microsoft. (Hoory Decl.,

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¶ 9), Exhibit A.

9. On November 20, 2014, the date scheduled for compliance with the summons, Microsoft appeared and provided a partial response to the summons but did not fully comply by producing all the books, records, papers, and other data as demanded in the summons. Microsoft's partial response included some documents and a letter dated November 20, 2014. (Hoory Decl., ¶ 10), Exhibit B.

10. The 2004-2006 Examination involves several unagreed international tax issues. The primary remaining areas on which the IRS needs additional information, and the focus of the designated summons, are transfer pricing issues involving intangibles and relating to two regional cost sharing arrangements between Microsoft and its affiliates. (Hoory Decl., ¶ 19).

11. Transfer pricing generally, and as embodied in 26 U.S.C. § 482, refers to the prices that related parties charge one another for goods and services transferred between them. The most common application of the transfer pricing rules is the determination of the correct price for transfers between related entities.

12. The IRS is authorized to allocate income and deductions among commonly controlled or owned entities as necessary to prevent tax avoidance or to clearly reflect the income of such entities. 26 U.S.C. § 482. In particular, when rights to intangible property are transferred or licensed between related entities, "the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." *Id.* "[T]he standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer." Treas. Reg. § 1.482-1(b)(1). Non-arm's length prices can be used to shift income, and thus the incidence of tax, to tax-favored jurisdictions.

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1 13. Microsoft divides its worldwide business operations into three geographic
2 regions: (1) Europe, Middle-East & Africa (“EMEA”); (2) Asia-Pacific (“APAC”); and (3) the
3 United States, Canada & Latin America (“Americas”). In each region it has entered into a cost
4 sharing arrangement with an affiliate. (Hoory Decl., ¶ 20).

5 14. Through a number of intercompany agreements, Microsoft entered into a cost
6 sharing arrangement with its Puerto Rican affiliate, Microsoft Operations Puerto Rico, LLC
7 (“MOPR”), effective July 1, 2005 (the “Americas cost sharing arrangement”). Under this
8 arrangement, Microsoft divided rights to technology intangibles (e.g., software code) from rights
9 to non-technology intangibles (everything other than technology intangibles, such as brands,
10 trademarks and customer/partner relationships) supporting its Americas retail business. This
11 division is distinct from Microsoft’s other cost sharing arrangements; Microsoft did not divide
12 technology and non-technology intangible rights in its cost sharing arrangements for APAC and
13 EMEA. Microsoft transferred to MOPR various rights to technology intangibles used in its
14 Americas retail business, while retaining rights to all non-technology intangibles. (Hoory Decl.,
15 ¶ 21).

16 15. As a result of the Americas cost sharing arrangement, Microsoft treated MOPR,
17 for transfer pricing purposes, as the economic owner of all technology intangibles supporting its
18 Americas retail business and paid MOPR a share of the revenues from that business, based on
19 the relative shares of profit that Microsoft allocated to technology intangibles and to non-
20 technology intangibles. (Hoory Decl., ¶ 22).

21 16. To value the technology intangible rights that were transferred, and also to set the
22 compensation that Microsoft would pay MOPR as the deemed owner of technology intangibles

1 after the transfer, Microsoft relied on certain assumptions about both historical and forecasted
2 revenues and expenses. The valuation methodology adopted by Microsoft used research and
3 development expenses and a subset of sales and marketing expenses to estimate the relative
4 values of technology and non-technology intangibles to its Americas retail business. (Hoory
5 Decl., ¶ 23).

6 17. Through a number of intercompany agreements, Microsoft entered into a cost
7 sharing arrangement with its affiliate, Microsoft Asia Island Limited (“MAIL”), a Bermuda
8 corporation, effective April 3, 2004 (the “APAC cost sharing arrangement”). Under this
9 arrangement (and in contrast to the Americas cost sharing arrangement), Microsoft transferred to
10 MAIL various rights to both technology and non-technology intangibles used in its APAC retail
11 business. (Hoory Decl., ¶ 24).

12 18. As the result of the APAC cost sharing arrangement, Microsoft treated MAIL, for
13 transfer pricing purposes, as the economic owner of all intangibles supporting its APAC retail
14 business. In valuing the intangible rights transferred to MAIL, however, Microsoft took the
15 position that, immediately prior to entering into the arrangement, Microsoft had owned only a
16 fraction of the non-technology intangibles used in its APAC retail business, thus limiting the
17 amount of compensation that MAIL would pay Microsoft for transferred non-technology
18 intangible rights. (Hoory Decl., ¶ 25).

19 19. To value the intangible rights transferred to MAIL, Microsoft relied on certain
20 assumptions about both historical and forecasted revenues and expenses. The valuation
21 methodology adopted by Microsoft used research and development expenses and a subset of
22 sales and marketing expenses to estimate the relative values of technology and non-technology

1 intangibles to its APAC retail business. (Hoory Decl., ¶ 26).

2 20. For transfer pricing purposes under 26 U.S.C. § 482, the Americas and APAC
3 cost sharing arrangements both require valuing the intangible rights that were transferred. In
4 addition, because only technology intangible rights were transferred in the Americas cost sharing
5 arrangement, that arrangement also requires an ongoing valuation of the relative contribution of
6 technology intangibles and non-technology intangibles to the Americas retail business. (Hoory
7 Decl., ¶ 27).

8 21. The valuation methodologies Microsoft applied to its APAC and Americas cost
9 sharing arrangements and the relative values that Microsoft adopted for the technology and non-
10 technology intangibles used in its Americas and APAC retail businesses have billions of dollars
11 of impact on Microsoft's taxable income in 2004, 2005, and 2006. (Hoory Decl., ¶ 28).

12 22. The information sought in the designated summons issued to Microsoft may be
13 relevant to the IRS's consideration of whether the transfer pricing Microsoft adopted for its
14 APAC and Americas cost sharing arrangements satisfies the arm's length pricing standard under
15 26 U.S.C. § 482 and the regulations thereunder. This includes, but is not limited to, evaluating
16 the relative values of the technology and non-technology intangibles that support those
17 businesses and evaluating the historical and forecasted revenues and expenses, including the
18 underlying assumptions on which Microsoft based its valuations. (Hoory Decl., ¶ 29).

19 23. Microsoft's refusal to fully comply with the summons continues to this date.
20 (Hoory Decl., ¶ 11).

21 24. Except for responsive documents produced on November 20, December 8, and
22 December 9, 2014, the books, records, papers, or other data sought by the summons are not

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1 already in the IRS's possession. (Hoory Decl., ¶ 12).

2 25. All administrative steps as required by the Internal Revenue Code for issuance
3 and service of a designated summons have been followed. (Hoory Decl., ¶¶ 9, 13).

4 26. The books, records, papers, and other data sought by the summons may be
5 relevant to determine Microsoft's correct federal tax liabilities for tax years ending June 30,
6 2004, June 30, 2005, and June 30, 2006. (Hoory Decl., ¶ 14).

7 27. There is no "Justice Department referral," as that term is described in Section
8 7602(d)(2) of the Internal Revenue Code, in effect with respect to Microsoft for the taxable years
9 ending June 30, 2004, June 30, 2005, and June 30, 2006. (Hoory Decl., ¶ 15).

10 28. In order to obtain enforcement of a summons, the petitioner must establish that
11 the summons: (1) is issued for a legitimate purpose; (2) seeks information relevant to that
12 purpose; (3) seeks information that is not already within the IRS's possession; and (4) satisfies
13 all administrative steps required by the Internal Revenue Code. *United States v. Powell*, 379
14 U.S. 48, 57-58, (1964).

15 29. In further support of this Petition and incorporated herein by reference, the United
16 States submits the Declaration of Senior International Advisor Eli Hoory. The United States has
17 met the *Powell* factors through this document.

18 WHEREFORE, petitioner, the United States of America, seeks the following relief:

19 A. That this Court enter an order directing Microsoft Corporation and includible
20 subsidiaries, to show cause in writing why it should not fully comply with and obey
21 the aforementioned Internal Revenue Service designated summons and every
22 requirement thereof as enumerated in the Declaration of Senior International Advisor

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1 Eli Hoory;

2 B. That this Court enter an order directing Microsoft Corporation and includible
3 subsidiaries, to fully obey the aforementioned designated summons and every
4 requirement thereof as enumerated in the Declaration of Senior International Advisor
5 Eli Hoory by producing all summoned books, records, papers, and other data
6 (including meta data) to Revenue Agent Odell, or any other proper officer or
7 employee of the Internal Revenue Service, at such time and place as may be fixed by
8 Revenue Agent Odell or any other proper officer or employee of the Internal Revenue
9 Service;

10 C. That the United States of America recover its costs in this action; and,
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1 D. That the Court grant such other further relief as it deems just and proper.

2 Dated this 11th day of December, 2014.

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4 Acting Assistant Attorney General

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